General Explanation of Charitable Remainder Trusts and Private Foundations

THE USE OF CHARITABLE TRUSTS can provide investment diversification without taxable gain, a larger stream of income during life, and an income tax deduction to the maker of the charitable trust. There is considerable flexibility in designing charitable remainder trusts and they are especially attractive to high net worth individuals who wish to use them in connection with their own private foundation which, in effect, passes control of the transferred assets to the next generation for their continued charitable purposes.

CHARITABLE REMAINDER TRUSTS

There are two basic types of charitable remainder trust: the "charitable remainder *annuity trust*" (CRAT) or a "charitable remainder *unitrust*" (CRUT). The difference between the two types of charitable remainder trusts is that in an *"annuity trust"* the annuity paid to you by the trust is based on a fixed percentage of the trust assets valued at the time the assets were contributed to the trust. You would continue to receive this fixed annuity amount for the rest of your life, A *"unitrust'* is designed so that the trust assets would be valued each year and you would receive a fixed percentage of the changing value of the trust as it grows (or decreases) from year to year. In other words, the *"annuity trust"* is a *fixed annuity* and the "unitrust" is a *variable annuity.*

The payout percentages to you may be at different interest rates (i.e., 6%, 7%, 8%, 9% and 10%). You can choose any of these rates; however, the greater the amount you retain as an annuity from the trust (whether a "unitrust" or an "annuity trust"), the less will ultimately pass to charity and the lower your income tax deduction for your gift to the charitable remainder trust. In other words, the lower the interest rate you pick, the higher the charitable deduction will be in the year you create the trust.

Selecting an Annuity Amount

I suggest that in making your decision, you should select a percentage that gives you the annuity amount you want and let the charitable deduction simply be whatever it is going to be, especially since, given your income level, you will likely not fully us the charitable deduction resulting from your gift to the trust. The charitable remainder trust will itself not pay any income tax (because it is a charitable trust) and will serve to shelter the proceeds received on the sale of investment assets in the trust an any dividends or interest income received – all of which will allow the assets in the Trust to grow faster than if the sale proceeds, dividends, and interest were taxable. You will be taxed only on your annuity payments as you receive them.

For example, if you create a nine percent charitable remainder unitrust payable to you for life and then to your private foundation, you would initially receive $45,000 as an annuity payment in the first year. Assuming the value of the Trust grows at a rate which is one percent above the nine percent annuity rate, i.e., at the rate of 10 percent, your annual annuity would increase to $47,295 per year in the sixth year. In the year the Trust is created and funded (1999), you will receive a charitable deduction of $285,600, but the amount of the deduction you will actually be allowed to use each year would be subject to an IRS limit equal to 20 percent of your "adjusted gross income" for that year. If your income, including the annuity payments, were $85,000, you would be able to actually use $17,700 as a charitable tax deduction; and , at a

combined federal and state tax rate of 34 percent (28 percent to Federal, six percent to State), you would save $5,780 in taxes you would otherwise owe. The unused amount of the $285,600 deduction not taken in 1999 would be available to be carried over and deducted (subject to the 20 percent limitation) from your income during the next five years (2000-2004).

You, or your children, of both of you, can serve as "trustee" of the charitable remainder trust.

Benefits of the Trust

Establishing a charitable remainder trust is an attractive way to increase your current income during your lifetime without paying the income taxes you would otherwise incur if you sold and reinvested the same amount of stock without such a Trust. At the same time, you will be funding a substantial gift that will ultimately go to the charity of your choice, which could be your own private foundation if you choose to establish one. In addition, you have the advantage of tax-free growth of the fund in the Trust which, in turn, increases the amount of your annuity payments each year (assuming you select a unitrust instead of an annuity trust).

Recent legislation has restored the rule which allows you an income tax deduction for the full value of your contribution of publicly traded stock (rather than just the cost basis) to your private foundation, and if you, in fact, choose to create a private foundation in conjunction with a charitable remainder trust, I recommend you fund your private foundation with a relatively small amount (say, $25,000) with your stock to get it started, and then create and fund a charitable remainder unitrust with from $200,000 to $500,000 of your stock to pay you income at the rate of 10 percent for your life and then to your private foundation. The increased income you will receive each year (the amount depending on your initial contribution to the trust, the interest rate chosen, and the growth of the trust fund) will allow you to make maximum annual exclusion gifts to your family as we previously discussed during your visit.

PRIVATE FOUNDATIONS

In general, you can establish a private foundation in your and your spouse's name (or using any name you wish) which will perpetuate your charitable intentions beyond your lifetime. The Foundation will allow you to take current charitable deductions for gifts to the Foundation while, at the same time, controlling both "when" and "which" charities will receive benefits. The Foundation is run by a board of trustees which would likely include you and your children and any others whom you may wish to have involved. Typically the trustees are the members of your family and, sometimes, an outsider. I generally recommend both a legal and financial advisor be on the Board.

One of the tax advantages of a charitable foundation is that you will be able to fund the Foundation with (low-basis, high-value) publicly traded stocks and receive an income tax deduction for the full value of the stocks without recognizing capital gain. An example of how you might fund the Foundation would be for you to contribute $500,000 of your stock which could be kept or sold by the Foundation as the Trustees see fit. You would receive a full $500,000 deduction which could be taken as a tax deduction against your other income during the current taxable year up to 20 percent of your "adjusted gross income". To the extent you cannot use the full deduction this year, the deduction will be carried forward for an additional five years. If this provision for gifts to private foundations is not restored in the current legislation, the deduction will be

limited to your tax basis (cost) in the contributed stock. There is, of course, no limitation on giving cash to the Foundation.

A private foundation is basically an IRS-approved charitable organization which is not a public charity, which is typically funded by one or a few donors. A private foundation (which is not an operating foundation) uses its assets to make grants for charitable purposes to other charitable organizations rather than conduction its own active charitable programs. If you wish, you can have your Foundation qualify as an “operating foundation” to conduct charitable activities or to grant individually directed scholarships for educational purposes. The additional IRS qualification needed can be handled at the same time as the regular IRS qualification of the Foundation as a charitable organization.

Private Foundation Advantages

One of the big advantages of a private foundation is that it is required to distribute only five percent of the value of its assets (valued at the beginning of the year) during any given year. For example, if the Foundations’ assets were valued at $500,000 in 2001, it would be required to distribute only $25,000 during the year. In the meantime, the fund can grow tax free (which is a big tax advantage of a charitable foundation). Since the assets of the Foundation will grow tax free, the growth of the funds will be enhanced by compound growth on amounts that would otherwise, if individually owned by you, be paid out in tax each year.

Family members who work for the Private Foundation (as a Board member) can receive compensation for services rendered. However, it is important to emphasize that there are strict rules regarding “self dealing” which are imposed on a Private Foundation. Therefore, compensation to family member (refered to as a “disqualified person”) must be inline with the services actually provided by the family member.